



STATE OF TENNESSEE
COMPTROLLER OF THE TREASURY

State Capitol
Nashville, Tennessee 37243-0260
(615) 741-2501

John G. Morgan
Comptroller

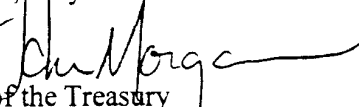
December 18, 2001

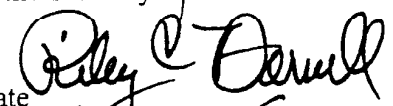
MEMORANDUM

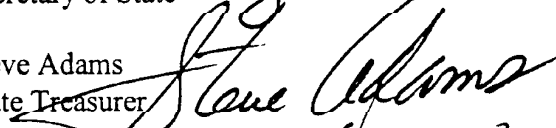
TO: The Honorable Don Sundquist
Governor


The Honorable Douglas Henry, Chairman
Senate Finance, Ways and Means Committee

FROM: The Honorable Matt Kisber, Chairman
House Finance, Ways and Means Committee

John Morgan 
Comptroller of the Treasury

Riley Darnell 
Secretary of State

Steve Adams 
State Treasurer

C. Warren Neel, Ph.D. 
Commissioner of Finance & Administration

SUBJECT: Revenue Estimates

The State Funding Board met on December 14, 2001 to hear presentations about the State's near-term economic outlook and estimates of State tax revenue collections for the fiscal years 2001-02 and 2002-2003. Presenters included Mr. Jim Davenport of the Fiscal Review Committee, Dr. Albert DePrince of Middle Tennessee State University, and Dr. William Fox of the University of Tennessee. Dr. John Gnuschke of the University of Memphis was unable to attend the meeting, but provided materials which were

distributed to members. A spreadsheet that summarizes the State tax revenue estimates as presented is attached to this memorandum (Attachment 1 for FY 2001-02 and Attachment 2 for FY 2002-03). The Board met again on December 18, 2000 to finalize its deliberations on ranges for tax revenue growth rates.

The Board is charged with responsibility to develop consensus ranges of revenue growth. In doing so, the Board evaluates and interprets economic data and revenue forecasts supplied by various economists as well as persons acquainted with the Tennessee revenue system. Since this is a revenue estimation process and not a budgeting process, the Board does not take into consideration the State's fiscal situation when developing its consensus ranges of revenue growth. Fiscal considerations properly belong with those who set the State's revenue estimates – the Administration that recommends appropriation levels based upon its assessment of revenue growth and the General Assembly that adopts a de facto revenue estimate through its final action on the appropriations bill. The Board wishes users of these consensus ranges to take notice that these ranges are not discounted in an attempt to add conservatism given the State's current fiscal condition.

Regarding the economy, it was noted that a national recession has existed since March 2001. The consensus of presenters was that Tennessee's economy has experienced this recession since at least that time. Presenters noted that the level of unemployment both nationally and in Tennessee is trending upward, leading to concerns about the willingness of Tennesseans to continue to consume and, thereby, generate sales tax revenue. Sales of technology items has weakened substantially over the last year. Purchase of such items has been the primary vehicle for business investment and weakening in this area also negatively impacts state revenues. Two key drivers of the sales tax, vehicle sales and home building, were also discussed. Auto sales, encouraged by special financing offers, have performed well, although at levels that are at unsustainable into the future. In a like manner, home building activity has been strong during 2001, fueled by lower mortgage rates; however, recent months have seen a decrease in volume to a level more consistent with the overall condition of the economy. Earnings reports have been less than encouraging in the corporate sector.

With regard to state tax revenues, presenters were in agreement that the current year revenue estimates would not be met. The range of undercollection for total taxes ran from a low of \$235 million to a high of \$372 million. The undercollection can be attributed primarily to the two engines of state revenue: the sales tax and the combined franchise and excise tax. The estimates reflect continued weakness in consumer and business purchases for the remainder of the year with a corresponding negative effect on sales tax collections. Corporate taxes were likewise impacted, with estimates reflecting weakness in corporate profits outlooks. As to FY 2002-03, all presenters project revenue growth driven by an economy pulling out of a recession; however, presenters differ on the timing and speed of the recovery. While projecting moderate levels of revenue growth, presenters were unable to identify specifically the drivers of this estimated growth. The

Board noted that other factors are at work which may impact revenue growth, including a potential decrease in capital gains taxed through the Hall income tax and the impact of federal fiscal stimulus legislation currently pending before Congress. Under the Hall income tax, dividend distributions arising from capital gains are taxable and, it is believed, account for 8% to 10% of total Hall tax revenues. Given the decreased valuations in the market over the last 18 months it seems likely that Hall income tax revenues will be negatively affected. As to the federal stimulus package, consideration is being given to providing shortened depreciation periods for certain assets. If enacted, this change will negatively impact collections of corporate taxes.

All presenters expressed a degree of caution as to their revenue estimates, noting that more downside risk was present than upside risk (i.e. it is more likely that their estimates will overstate revenue than understate revenue). Key to all the estimates are assumptions as to the timing and speed of recovery of the economy. Given this, caution is warranted. For example, one presenter noted that his revenue estimates could be overstated by 1/3rd to 1/2 if his timing of the recovery is not accurate.

Based upon the presentations made and discussions that followed, the Board has developed consensus revenue estimates for the current and next fiscal years. These estimates are expressed in ranges of growth rates in State tax revenue collections. The following table summarizes these estimates:

	<u>FY 2001-02</u>		<u>FY 2002-03</u>	
	Low	High	Low	High
Total State Taxes	(2.60)%	(1.60)%	2.25%	3.00%
General Fund Only	(2.80)%	(1.80)%	2.50%	3.25%

The Board believes these are reasonable estimates; however, as the Administration and General Assembly use these ranges to set a revenue estimate for budget purposes, the Board urges caution. In establishing a specific revenue estimate, there must be an awareness of the State's overall financial condition. Historically, fund balances in various reserves (including the revenue fluctuation reserve fund) have been available for use when the State experienced unexpected revenue shortfalls. Given the current year situation, these reserves may well be exhausted in meeting current year needs, leaving few reserve funds available to meet any revenue shortfall in FY 2002-03. Second, the estimated ranges for FY 2002-03 are based on assumptions as to when the national and state economies will begin a recovery from the current recession. Should these assumptions be overly optimistic, then the revenue growth ranges cited above will be overly optimistic. Lastly, other factors exist which may negatively impact state revenues and which cannot be quantified at this time. These include the impact of federal stimulus legislation and the impact of reduced capital gains on Hall income tax revenue.

With regard to the FY 2001-02 consensus growth rate ranges, it should be noted that the lower end of the range assumes performance during the remainder of the year exhibits patterns similar to that seen through November, while the upper end of the range assumes collections for the remainder of the year mimic collections for the same period during FY 2000-01 which would represent an improvement over current year experience. For FY 2002-03, the high end of the range assumes a recovery from the current recession during the second half of CY 2002, accompanied by a return to normal expenditure patterns by both individuals and businesses. The low end of the range assumes an economic recovery occurring during the first half of CY 2003. Using the high end of this range for budgetary purposes is accompanied by significant risk. For budgetary purposes, the Board would encourage use of conservative revenue estimates.

As in past years, the Board intends to revisit the estimates prior to the General Assembly's final budget deliberations. At that time, updated information should be available on all tax collections, particularly those of our major tax types, the sales, franchise and excise tax. Each of you will be advised of any revisions made by the Board at that time.

We will be happy to discuss these matters with you further at your convenience.

Attachments

cc. The Honorable John S. Wilder
The Honorable Jimmy Naifeh

COMPARISON OF ESTIMATED STATE TAX REVENUE FOR
FISCAL YEAR 2001-2002
(Accrual-Basis Estimates)

2001-2002

DEPARTMENT OF REVENUE	2000-2001 ACTUAL	2001-2002 ESTIMATE	2001-2002 % Change	2001-2002 ESTIMATE	2001-2002 % Change	2001-2002 ESTIMATE	2001-2002 % Change	2001-2002 ESTIMATE	2001-2002 % Change	2001-2002 ESTIMATE	2001-2002 % Change
SOURCE OF REVENUE	COLLECTIONS	ESTIMATE	% Change	ESTIMATE	% Change	ESTIMATE	% Change	ESTIMATE	% Change	ESTIMATE	% Change
Sales and Use Tax	\$4,643,337,500	\$4,785,760,000	3.07%	\$4,619,500,000	-0.51%	\$4,582,646,000	-1.31%	\$4,647,700,000	0.09%	\$4,563,000,000	-1.73%
Gasoline Tax	569,421,100	578,000,000	1.51%	578,000,000	1.51%	571,214,000	0.31%	579,900,000	1.84%	597,100,000	4.86%
Motor Fuel Tax	173,417,700	149,760,000	-13.58%	151,000,000	-12.93%	142,276,000	-17.96%	149,300,000	-13.91%	181,900,000	4.89%
Gasoline Inspection Tax	61,486,900	63,160,000	2.62%	63,500,000	3.27%	64,319,000	4.61%	63,600,000	3.44%	67,300,000	9.45%
Motor Vehicle Registration Tax	211,427,500	218,500,000	3.35%	218,500,000	3.35%	213,961,000	1.20%	220,600,000	4.34%	231,400,000	9.45%
Income Tax	199,397,100	204,880,000	2.71%	204,500,000	2.56%	199,990,000	0.30%	201,200,000	2.41%	218,300,000	9.48%
Privilege Tax - Less Earmarked Portion (1)	160,766,200	166,760,000	3.69%	166,300,000	3.44%	166,700,000	3.69%	169,000,000	1.11%	176,000,000	9.48%
Gross Receipts Tax - TVA	226,334,500	198,300,000	-12.39%	198,300,000	-12.39%	199,470,000	-11.87%	198,300,000	-12.39%	198,300,000	-12.39%
Gross Receipts Tax - Other	22,266,400	23,300,000	4.54%	23,300,000	4.54%	22,489,000	1.00%	21,800,000	-2.09%	23,300,000	4.84%
Beer Tax	15,476,600	16,200,000	4.57%	16,100,000	4.03%	16,018,000	3.50%	16,000,000	3.38%	16,900,000	9.20%
Alcoholic Beverage Tax	30,043,100	31,000,000	3.19%	31,000,000	3.19%	30,966,000	3.07%	31,100,000	3.52%	32,900,000	9.51%
Franchise & Excise Taxes	1,102,801,300	1,150,200,000	4.30%	1,075,000,000	-2.52%	1,000,000,000	-9.32%	1,000,700,000	-9.26%	1,158,000,000	5.01%
Inheritance and Estate Tax	89,676,300	91,150,000	1.54%	95,400,000	6.38%	95,931,000	6.37%	92,800,000	-3.48%	98,200,000	9.50%
Tobacco Tax	82,814,000	82,800,000	-0.02%	82,600,000	-0.26%	82,814,000	0.00%	85,700,000	3.48%	90,600,000	9.40%
Motor Vehicle Title Fees	10,646,700	10,800,000	1.44%	11,100,000	4.26%	10,444,000	-1.50%	11,000,000	3.32%	11,700,000	9.99%
Mixed Drink Tax	34,334,500	35,880,000	4.27%	36,100,000	5.14%	35,021,000	2.00%	35,500,000	3.39%	37,600,000	9.51%
Business Tax	21,509,100	22,460,000	4.14%	22,300,000	3.68%	21,250,000	-1.20%	22,300,000	3.68%	23,500,000	9.26%
Severance Tax	1,140,700	1,000,000	-12.33%	1,100,000	-3.57%	1,000,000	-12.33%	1,200,000	5.20%	1,200,000	5.20%
Coin Operated Amusement Tax	58,500	-	-100.00%	-	-100.00%	50,000	-14.53%	100,000	NA	100,000	70.34%
All Other taxes	-	-	NA	-	NA	-	NA	-	NA	-	NA
TOTAL DEPARTMENT OF REVENUE	\$7,656,355,000	\$7,829,230,000	2.26%	\$7,593,600,000	-0.82%	\$7,456,559,000	-2.61%	\$7,550,800,000	-1.38%	\$7,727,300,000	0.33%
GENERAL - FUND ONLY (2)	\$6,143,510,200	\$6,320,850,000	2.89%	\$6,089,100,000	-0.89%	\$5,974,159,000	-2.76%	\$6,041,500,000	-1.63%	\$6,155,700,000	0.20%
Budgeted Est. Compared to New Est. - Total				-\$235,650,000		-\$372,691,000		-\$278,450,000		-\$101,950,000	
Budgeted Est. Compared to New Est. - Gen. Fund				-\$231,750,000		-\$346,691,000		-\$277,350,000		-\$165,150,000	
SELECTED TAXES	ACTUAL	BUDGETED	%	DR. FOX	%	FISCAL REVIEW	%	DR. DEPRINCE	%	DR. GRUSCHKE	%
SALES AND USE TAX	\$4,643,337,500	\$4,785,760,000	3.07%	\$4,619,500,000	-0.51%	\$4,582,646,000	-1.31%	\$4,647,700,000	0.09%	\$4,563,000,000	-1.73%
FRANCHISE AND EXCISE TAXES	1,102,801,300	1,150,200,000	4.30%	1,075,000,000	-2.52%	1,000,000,000	-9.32%	1,000,700,000	-9.26%	1,158,000,000	5.01%
ALL OTHER TAXES	1,910,217,000	1,893,310,000	-0.98%	1,899,100,000	-0.58%	1,873,913,000	-1.90%	1,901,400,000	-0.41%	2,006,300,000	5.03%

(1) Privilege Tax estimates are reduced by \$31,700,000 in 2001-2002 for the earmarked portion of the tax.

(2) F&A calculated the General Fund distribution for all presenters.

* F&A distributed taxes for Dr. DePrince and for Dr. Gruschke based on ratios for actual collections in 2000-2001.

** F&A distributed the Gross Receipts Taxes for Dr. DePrince and Dr. Gruschke based on anticipated TVA collections in 2001-2002.

COMPARISON OF ESTIMATED STATE TAX REVENUE FOR

FISCAL YEAR 2002-2003

(Accrual - Basis Estimates)

2002-2003

DEPARTMENT OF REVENUE

SOURCE OF REVENUE	DR. FOX	% Change	FISCAL REVIEW	% Change	DR. DePRINCE	% Change	DR. GINSCHKE	% Change
Sales and Use Tax	\$ 4,781,200,000	3.50%	\$ 4,697,212,000	2.50%	\$ 4,787,300,000	3.00%	4,557,000,000	-0.13%
Gasoline Tax	586,600,000	1.49%	579,782,000	1.50%	588,100,000	1.41%	653,900,000	9.51%
Motor Fuel Tax	156,300,000	3.51%	146,544,000	3.00%	157,400,000	5.43%	199,100,000	9.46%
Gasoline Inspection Tax	64,800,000	2.05%	65,605,000	2.00%	66,100,000	3.93%	74,500,000	10.70%
Motor Vehicle Registration Tax	227,200,000	3.98%	219,310,000	2.50%	222,800,000	1.00%	256,200,000	10.72%
Income Tax	214,700,000	4.95%	205,990,000	3.00%	214,200,000	4.90%	241,600,000	10.57%
Privilege Tax - Less Earmarked Portion (1)	171,900,000 (1)	3.37%	171,701,000	3.00%	175,000,000 (1)	3.55%	194,800,000	10.38%
Gross Receipts Tax - TVA	202,300,000	2.02%	203,459,000	2.00%	202,300,000	2.02%	202,300,000	0.00%
Gross Receipts Tax - Other	24,400,000	4.72%	22,939,000	2.00%	23,800,000	9.17%	24,400,000	4.72%
Beer Tax	16,300,000	1.24%	16,178,000	1.00%	16,600,000	3.75%	18,800,000	11.24%
Alcoholic Beverage Tax	31,800,000	2.58%	31,276,000	1.00%	32,300,000	3.86%	36,400,000	10.34%
Franchise & Excise Taxes	1,075,000,000	0.00%	1,050,000,000	5.00%	1,057,700,000	5.70%	1,283,000,000	10.79%
Inheritance and Estate Tax	90,000,000	-5.66%	97,850,000	2.00%	96,400,000	3.88%	108,700,000	10.39%
Tobacco Tax	82,600,000	0.00%	82,814,000	0.00%	89,100,000	3.97%	100,300,000	10.71%
Motor Vehicle Title Fees	11,300,000	1.80%	10,653,000	2.00%	11,400,000	3.64%	12,900,000	10.26%
Mixed Drink Tax	37,100,000	2.77%	35,897,000	2.50%	36,900,000	3.94%	41,600,000	10.84%
Business Tax	23,200,000	4.04%	21,675,000	2.00%	23,100,000	3.59%	26,100,000	11.06%
Severance Tax	1,100,000	0.00%	1,000,000	0.00%	1,200,000	0.00%	1,400,000	16.67%
Coin Operated Amusement Tax	-	NA	50,000	0.00%	100,000	NA	100,000	0.00%
All Other Taxes	-	NA	-	NA	-	NA	-	NA
TOTAL DEPARTMENT OF REVENUE	\$ 7,797,800,000	2.69%	\$ 7,659,935,000	2.73%	\$ 7,801,000,000	3.32%	\$ 8,033,100,000	3.96%
GENERAL FUND ONLY (2)	\$ 6,257,200,000	2.76%	\$ 6,149,435,000	2.93%	\$ 6,261,700,000	3.53%	\$ 6,348,400,000	3.13%
Growth over FY 02 Budgeted Est. - Total	-\$31,450,000		-\$169,315,000		-\$27,450,000		\$203,850,000	
Growth over FY 02 Budgeted Est. - Gen. Fund	-\$63,650,000		-\$171,415,000		-\$59,150,000		\$27,550,000	
SELECTED TAXES	DR. FOX	%	FISCAL REVIEW	%	DR. DePRINCE	%	DR. GINSCHKE	%
SALES AND USE TAX	\$ 4,781,200,000	3.50%	\$ 4,697,212,000	2.50%	\$ 4,787,300,000	3.00%	\$ 4,557,000,000	-0.13%
FRANCHISE AND EXCISE TAXES	1,075,000,000	0.00%	1,050,000,000	5.00%	1,057,700,000	5.70%	1,283,000,000	10.79%
ALL OTHER TAXES	1,941,600,000	2.24%	1,912,723,000	2.07%	1,956,800,000	2.86%	2,193,100,000	9.31%

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